PANTHEON MACROECONOMICS

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The ISM index doesn't signal a broad recession, yet, but manufacturing is in deep trouble.

The widening gap between U.S. and Chinese PMI surveys signals that the trade war is hurting, badly.

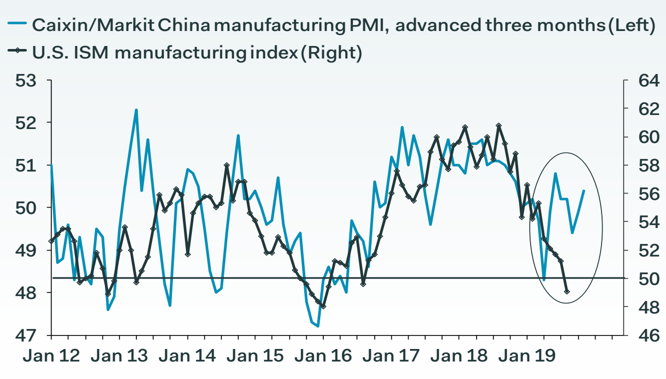
Auto sales likely fell again August, but it's not yet clear if the dip is noise or a worrying signal.

The Manufacturing Rollover Worsens; Blame the Trade War

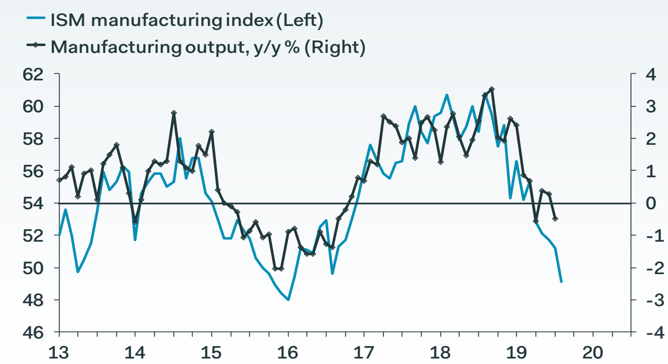
We have argued for some time that much of the early phase of the downturn in global manufacturing was due to the weakening of China's economic cycle, rather than the trade war. *Now, however, the balance appears to be shifting.* To be clear, China's manufacturing sector is not yet recovering; indeed, we think it likely that the authorities are unhappy with the lack of response to their easing measures to date. But the Caixin manufacturing index is no longer falling, while the ISM new orders index dropped to 47.2 in August from 50.8, matching its seven-year low, despite upticks in several of the key regional PMIs and Fed surveys released in previous weeks.

The widening wedge between the Caixin index and the ISM represents, at least to some extent, the damage done by the trade war. Had the usual relationship between the surveys continued, the ISM would now stand at about 54, consistent with zero growth in manufacturing output, rather less terrible than the -2½% now signalled by the survey. Official data show that output was down only 0.5% year-over-year in July, so the outlook for the next few months is grim. *The third quarter is very likely to be the third straight quarter to record falling manufacturing output, quarter-to-quarter.*

THE WIDENING CAIXIN/ISM WEDGE IS ALARMING



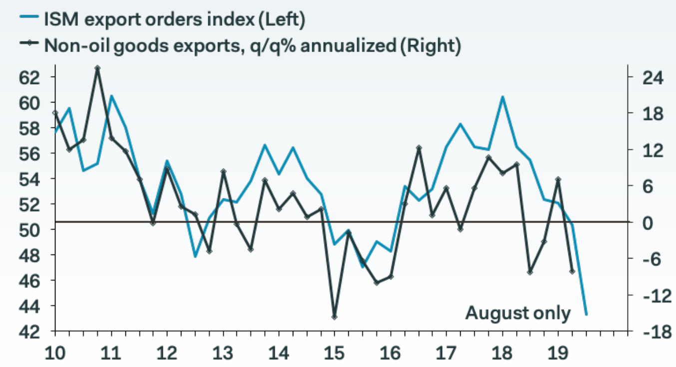
MANUFACTURING OUTPUT HAS FURTHER TO FALL



The export picture is even worse, with the orders index dropping to just 43.3 from 48.1, hitting its lowest point since April 2009. Back then, world trade was collapsing as banks were unable to provide credit to keep goods moving, but at least the rebound was quite quick, with the export orders index rising by almost 20 points in the year to December 2009. A quick resolution to the trade war probably would not trigger quite such a dramatic rebound, but we have no doubt that it would stop the rot very quickly.

Unfortunately we're struggling to think of reasons why the required policy U-turn on the part of Mr. Trump might be imminent. It's coming, we think, once he begins properly to appreciate that Chinese are not going to fold and that the tariffs are a serious threat to his chance of re-election. But not yet. *That means we have to take seriously the message from the ISM export orders index, which points to a dramatic plunge in exports over the next few months, as our next chart shows.* We had been hoping that net trade would not be a serious drag on overall economic growth in the second half of this year

EXPORT ORDERS ARE CRATERING



and the early part or next year, but we're now becoming very nervous that a real rollover is coming.

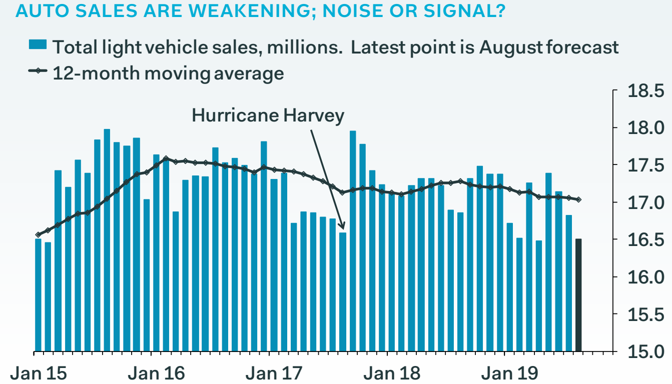
The headline ISM index is not yet bad enough to signal a recession in the broad economy—that requires a further drop of five points or so—or outright declines in payrolls. But it is weak, and still weakening, with no end in sight to the downshift. ***If the President and his economic advisers aren't now nervous about the outlook, they should be.***

Auto sales down again; noise or trend?

Today brings the first hard data on consumers' spending in August, in the form of the automakers' unit auto numbers. Industry-watchers think sales dipped a bit from July's 16.8M, to perhaps 16.5M or so. *Auto sales forecasts are often wrong, but if these estimates are right they mark the third straight decline from this year's peak sales month, 17.4M in July.* Sales were never likely to be sustained at that level, but it appears that August sales were some way below the trend, as our next chart shows.

The August dip is not *necessarily* a sign that the trend in auto sales is now falling. Sales are erratic, even when the trend is stable, and substantial short-term shifts can be triggered by relatively modest movements in the incentives offered to buyers by the manufacturers. *But we can't ignore the possibility that the recent wobbles in some measures of consumer confidence, which appear to have been triggered by the threat—now a reality—of tariffs on consumer goods, have persuaded at least some would-be purchasers of new autos to hold back.*

AUTO SALES ARE WEAKENING; NOISE OR SIGNAL?

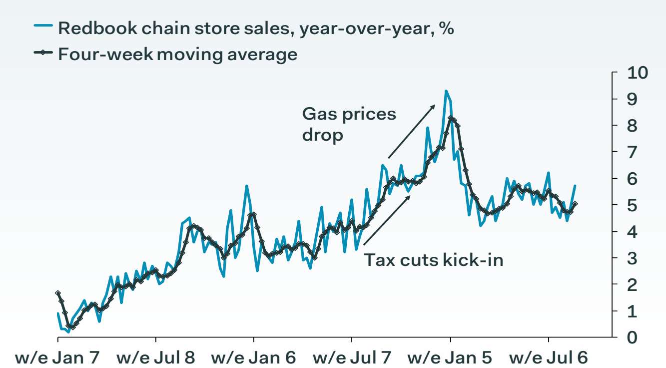


If August forecasts are right, auto sales would have to rebound to an implausible 17.7M in September in order to prevent a decline in sales across the third quarter as a whole. That's not necessarily a disaster, given that auto sales account for only 2.0% of total consumption spending. But if the decline in sales is a sign that consumers are becoming more cautious, it does not augur well for the upcoming holiday shopping season.

So far, we detect no weakening in spending on smaller-ticket items; indeed, the Redbook chainstore sales numbers have surprised us to the upside over the past couple of weeks. The underlying trend in same-store year-over-year sales growth probably is slowing, under pressure from adverse base effects after sales were boosted by the tax cuts last year. But the implied month-to-month path of core retail sales remains strong, and we'd now be surprised to see real third quarter consumption rising by much less than 3%.

The real question, now, though, is what happens in the fourth quarter and beyond. The most recent omens are discouraging, though not yet definitive. *Retailers, we suspect, are now rapidly ratcheting-down their expectations for the holidays.*

CHAINSTORE SALES GROWTH HAS SLOWED, BUT NO ROLLOVER



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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, Sept 2

• Holiday, Labor Day

Tuesday, Sept 3

• D: ISM Manufacturing Survey (8)/10.00 EDT

The headline index fell to **49.1,** the lowest reading since January 2016, from 51.2. New orders dropped below 50 for the first time since December 2015, hitting 47.2, while new export orders plunged to just 43.3, the lowest since April 2009. Employment fell too.

• D: Construction (7)/10.00 EDT

Spending rose just **0.1%,** but note that June spending was revised up by 0.6 percentage points. The early estimates are very unreliable.

Wednesday, Sept 4

• Mortgage Applications (8/30)/7:00 EDT

The purchase applications index always falls in August but we expect a modest uptick after last week's 4.0% fall, to **234.1.**

• D: International Trade (7)/8.30 EDT

Last week's advance data on goods trade suggest that the deficit fell to **$53.4B** from $55.2B. **Consensus: $53.4B.**

• Redbook Chain Store Sales (8/31)/9.00 EDT

We expect a correction after last week's unexpected jump in same-store sales growth to **5.7%** from 4.9%; the trend is nearer 4½%, and slowing under the weight of adverse base effects. Sales were boosted last summer by the tax cuts.

• Auto Sales (8)/Late Afternoon EDT

Industry watchers at Cox thinks sales dipped to 16.5M from 16.8M, while Edmunds forecasts 16.6M. **Consensus: 16.8M.**

Thursday, Sept 5

• D: Jobless Claims (8/31)/8:30 EDT

Seasonal adjustment issues suggest that claims dipped slightly, to about **210K** from 215K. **Consensus: 215K.**

• D: ADP Employment (8)/8:15 EDT

Our model suggests that ADP will report a **160K** increase in private sector payrolls, little changed from the July reading. Labor demand has dipped but remains quite strong. **Consensus: 150K.**

• Productivity and Unit Labor Costs (Q2r)/8:30 EDT

The second estimate of Q2 GDP growth suggests that productivity growth and unit labor costs will be unrevised, at **2.3%** and **2.4%** respectively. **Consensus: Productivity 2.2%, unit labor costs 2.5%.**

• Factory Orders (7)/10:00 EDT

The 2.1% aircraft-led jump in durable goods orders suggests that total orders rose about **1.3%. Consensus: 1.0%.**

• D: ISM Non-manufacturing Survey (8)/10.00 EDT

The index undershot substantially in July, compared to the pace implied by the rate of growth of core retail sales. We expect a modest rebound in August, to **55.0** from 53.7, but the threat of tariffs on imported consumer goods likely will prevent a bigger recovery; the sales numbers point to reading close to 59 or so. **Consensus: 54.0.**

Friday, Sept 6

• D: Employment (8)/8:30 EDT

Survey-based models point to payrolls rising by about 200K but we think the latest developments in the trade war will have slowed hiring a bit, so we look for a **170K** increase. The unemployment rate likely was unchanged at **3.7%.** We expect a **0.3%** increase in hourly earnings, for the fourth straight month. **Consensus: Payrolls 168K, unemployment 3.7%, average hourly earnings 0.3%.**

THIS WEEK'S FUNDING

Monday 2	Nothing
Tuesday 3	Auction: $45B 3-month, $42B 6-month bills
	Announcement: four-week bills, eight-week bills
Wednesday 4	Announcement: 3-year notes (Sep. 10)
	Announcement: 10-year notes (Sep. 11)
	Announcement: 30-year bonds (Sep. 11)
Thursday 5	Announcement: 3-month, 6-month bills (Sep. 9)
	Announcement: 1-year bills (Sep. 10)
	Auction: four-week bills, eight-week bills
Friday 6	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Mon.	Sep	Dec	Mar	Jun
Fed funds target	2¼-to-2½	1¾-to-2	1¾-to-2	1¾-to-2	2-to-2¼
2-yr	1.46	1.70	2.00	2.20	2.40
10-yr	1.47	1.70	2.20	2.50	2.70
30-yr	1.96	2.20	2.70	3.00	3.30
Curve 10-2	1	0	20	30	30
Curve 30-2	50	50	70	80	90
S&P 500	2,906	2,900	2,875	2,850	2,900
Dollar/Yen	106.0	111	113	114	114
Euro/Dollar	1.10	1.15	1.15	1.15	1.15
Sterling/Dollar	1.21	1.36	1.30	1.32	1.35

PANTHEON'S ECONOMIC FORECASTS

GDP	Q3	3.4%	2015 year:	2.6%
	Q4	2.2%	2016 year:	1.6%
	Q1	3.1%	2017 year:	2.3%
	Q2 second	2.0%	2018 year:	2.9%
	Q3 forecast	*2½%*	*2019 year:*	*2.6%*
	Q4 forecast	*2½%*		
CPI	July 0.3% (1.8% y/y); core 0.3% (2.2% y/y)			
	September forecast: 2.0% y/y; core 2.3% y/y			
	December forecast: 2.3% y/y; core 2.5% y/y			

Unemployment: December 2019: 3.4%; June 2020: 3.3%.

Federal budget: FY 19 forecast: -$950B (4.5% of GDP)